Notes for Meeting of July 26, 2000
Market Mechanisms for Student Loans
Student Loan Study Group 2—Section 801 Study

Attendees

Nabeel Alsalam	Congressional Budget Office
Bill Beckmann	Student Loan Corporation
Barbara Bovbjerg	General Accounting Office
Judy Case	University of Massachusetts Medical School
Rene Champagne	ITT Educational Services
Robert Cumby	Department of the Treasury
Sarah Ducich	Sallie Mae, Inc., (for Tony Dolanski)
Don Feuerstein	New America Schools
Robert Franciscus	Fitch, IBCA Inc, (for Claire Mezzanotte)
Ivan Frishberg	U.S. Public Interest Research Group Higher Education Project
Dick George	Great Lakes Higher Education Corporation
Bruce Johnstone	SUNY Buffalo
James Lintzenich	USA Group
Gail Norris	Utah Higher Education Assistance Authority
Maureen McLaughlin	Department of Education
Scott Miller	Pennsylvania Higher Education Assistance Agency (for Michael Hershock)
David Mohning	Vanderbilt University
Barmak Nassirian	American Assoc. of Collegiate Registrars and Admissions Officers
Susan Pugh	Indiana University
Dick Pierce	Maine Education Services
Marilyn Quinn	Delaware Higher Education Commission
Lorenzo Rasetti	Office of Management and Budget
Pat Smith	American Association of State Colleges and Universities
Paul Tone	UNIPAC
Laurie Wolf	Des Moines Area Community Colleges
Paul Wozniak	Paine Webber Incorporated

Other government staff

Department of Education	David Bergeron, Daniel Pollard
General Accounting Office	Diana Pietrowiak, Jim Spaulding, Mitch Rachlis, Timothy Carr Gene Kuehneman, Howard Wial, Edward Bodine, Joy Gambino
Department of the Treasury	Susan Lepper, Lucy Huffman, Phil Quinn, Liz Askey

Introductory Remarks

Barbara Bovbjerg welcomed participants and discussed the format of the day's meeting. Maureen McLaughlin discussed the categorization of the various proposals previously submitted, noting that for purposes of this meeting and the ultimate report there would be five items to consider. The generic approaches will be grouped as: adjustments to the current FFELP system, a Treasury funding model, two auction variations (for loan origination rights and for loan paper) and a "student shop" model. In addition, there will be discussion of income-contingent repayment. Maureen then introduced Don Feuerstein.

Don Feuerstein Presentation

Don gave a two-part presentation, focusing first on income contingent repayment (ICR) and then on market mechanisms. He began with a description of two failed attempts to establish ICR as a component of the student loan program: (1) the attempt by the Administration to initiate market mechanisms to set the lender yield, and (2) the attempt by New Jersey Congressman Andrews to push ICR through Congressional legislation. Despite the limited success of the reform, Feuerstein argued that enactment of such a measure would be critical to ensuring access and equity in the nation's higher education system. The mandate to analyze market mechanisms and ICR was added to explore the possibility of both saving money and addressing social problems in the loan programs.

According to Don, any successful market mechanism enacted must include a provision for ICR. He went on to explain that two funding systems for higher education exist: (1) the grant system, in which students are awarded funding without the expectation of repayment, and (2) the loan program, in which students finance their higher education and are expected to repay both the principal and the interest upon graduation. Somewhere between these two systems lies the option for income contingent repayment: a system in which loan repayment hinges on whether or not the initial investment in higher education results in economic returns sufficient to meet repayment obligations. He noted that the current generation of students will be paying back 40 percent more in real dollars than did the previous generation. This is because of both higher debt levels and much lower inflation today--the previous generation paid back loans in dollars that were worth much less than what they borrowed because of average inflation rates of 8 percent. Although Don did not recommend a particular formula for ICR, he noted its inclusion in the Direct Loan (DL) program and advocated consistency across both DL and FFELP. The most obvious way to pay for ICR, if it involves a cost, is to move to federal funding. Potentially, up to $1 billion could be saved in what, to the government, appears as excessive costs related to private funding of student loans.

The model includes the origination of loans through a non-federal entity or entities such as user co-operatives, states, and/or clusters of schools. This entity would receive federal funding in order to originate loans, and private lenders would bid at auction to buy and service loans. Don remarked that lenders would bid on "balanced packages," meaning that each package contains a mix of loans from two and four-year, public, private and proprietary schools. With balanced packages, some level of cross-subsidization occurs between sectors. The originating entity would be required to deal with all lenders (not unlike a public utility) and every eligible borrower would be entitled to receive a loan. Congress would set borrower rates as a matter of social policy. Lenders who purchase loans would make some initial down payment and then pay for the purchases over time. Lenders would have no interest rate risk. Since loans would have no guarantee, lenders would bear default risk, but lenders know how to manage that (using their normal collection practices). If delinquent borrowers were eligible for ICR, lenders would have an incentive to get them into ICR. Whether private loanholders administer ICR, using IRS data, or whether the government purchases loans going into ICR and administers the program itself, could be decided on the basis of administrative efficiency and the prospects for access to IRS data. Finally, technology should provide a method to give borrowers a virtual single lender for purposes of making repayments.

Upon conclusion of the presentation, Gail Norris asked about the degree to which this model could continue to use the current decentralized loan delivery system and whether an ICR plan could be universally financed without resorting to Treasury funds. Don explained first that this model would take lenders out of the funding role--but for many lenders, funding is done centrally within their organization now, rather than student loans having their own funding operation. Second, there might be another source of funding, but such a system would eliminate the need for a federal subsidy since lenders' bids would reflect the value they assigned to the future income stream of borrowers' repayment.

Some participants disagreed on whether the proposal, by eliminating the origination function of private lenders, would leave those lenders with any meaningful role. Don said that the proposal would eliminate lenders' marketing and funding roles but would maintain their servicing function. Bill Beckmann stated that marketing is really customer service and that the proposal eliminates lenders by taking the origination function away from them, making them simply third-party servicers. Don stated that as long as the lenders could service loans, their role remained important.

Questions arose regarding the in-school interest subsidy, the $1 billion of potential savings, the role of guarantee agencies, and the effect of the proposal on consolidation in the student loan industry. Don stated that his proposal was neutral on the in-school interest subsidy--it could still be set as social policy. The $1 billion includes special allowance payments (including the McKeon-Kildee subsidy), costs related to the guarantee itself, and costs related to guaranty agencies. The proposal eliminates guaranty agencies. It is difficult to tell how the proposal would affect consolidation in the industry.

Adjustments to the Current System

Jim Spaulding presented three models to reform the current system, emphasizing that the alternatives proposed by both Gail Norris and Art Hauptman would induce incremental change while curtailing the responsibility of the Congress to set lender yield. Following Jim's presentation, discussion ensued on the degree to which the current system embraced competition and whether or not lender yield is already determined through market forces.

Barmak Nassirian maintained that the use of secondary market information to set lender yields was the only adjustment to the current system that was both feasible and a market mechanism. Discussion focused on this option. Barmak argued that it could (1) reduce access to capital, (2) reduce lenders' margins over time and (3) induce lenders' departure from the market. Bob Cumby argued that, on the contrary, it would only lead to the discovery of a market equilibrium, at which lenders' margins would be just sufficient to keep them in the market.

Art Hauptman stated that the real issue is profitability rather than competition. He spoke about his proposal, which he believed would reduce lenders' profits with minimal disruption to the current system. He identified the SAP as the source of excess payments by the federal government to lenders. He noted that the difference in lender rates between the in-school and repayment periods, currently set by statute, could also be determined by a market mechanism. Furthermore, he stated that any mechanism to reduce lender profit would require (1) ease of implementation and (2) the minimum burden to student borrowers. His proposal also called for an auction of servicing rights to find out the "real" price of servicing and impose a market mechanism on the servicing industry. Gail Norris agreed that the models are not, strictly speaking, market mechanisms that determine the yield, but he felt it was not unreasonable to look to market information to better set the yield.

Sarah Ducich stated that the biggest federal costs in the current system are the in-school interest subsidy and the loan guarantee. The adjustments to the current system discussed today do not affect these costs; they only affect the difference between borrower and lender rates, which she viewed as a minor cost.

Additional discussion followed regarding the language of the mandate. Participants did not agree on whether market mechanisms could be added to the current system without altering the system fundamentally. Barmak reminded the participants that the task was to change the determination of market yield, and Lucy Huffman said that to accomplish this task, current relationships between the federal government, private lenders, and the student borrowing community might have to change as well. Before the discussion closed, Susan Pugh requested that GAO and Education develop a matrix that could visually represent the areas in which each reform proposal differed. She suggested applying the same criteria across each model to make the comparisons more meaningful and the variations of each proposal clearer.

Treasury Funding

Nabeel Alsalam presented the outline of the Treasury funding model, which has two principal features: (1) the federal government would discontinue the SAP, and (2) lenders could turn to the Department of the Treasury for loan capital. Under this model, all other provisions of the FFEL program would remain the same. According to Nabeel, this proposal affects net yield by influencing lenders' funding costs rather than their gross yield. The proposal eliminates basis risk for lenders. Since this model eliminates the SAP, yet offers lenders a borrowing rate lower than any that than they could obtain in the private sector, lenders are essentially compelled to seek their capital from Treasury if they aim to stay in business.

After describing this proposal, Nabeel stated that this model reduces the federal government's costs because the federal government has a lower cost of funds than private lenders. However, taxpayers could incur liability should borrowers default and lenders fail to make repayment to the Treasury. While participants noted that the current system of federal guarantee bears the same risk, Nabeel noted that federal financing of loans through the Treasury would use funds from the general treasury rather than costs estimated from Education's budget alone. Additional concern surfaced as to whether or not it is the federal government's role to provide capital to private lenders at sub-market rates. Bob Cumby, Susan Lepper, and Paul Wozniak agreed that Treasury should not assume this role, at least not at a fixed sub-market rate.

Participants seemed to disagree with regard to the status of FFELP loans made in this system and the necessity of an auction system given Treasury funding. Bob raised the issues of whether the loans would be collateral for what lenders had borrowed from Treasury and what happened if the FFELP loan was later sold--would the funding follow through to the purchaser, or would the original holder have to repay Treasury immediately? Paul offered several views of such a system, including as a line-of-credit to lenders, as simple lending, or as securitized lending. Treasury representatives stated that a bidding system would be essential to ensure a market rate closest to the rate paid by students since the SAP would be eliminated. Bill and Paul argued that the CP already sets this rate and there is no need for another mechanism to alter the way in which lenders acquire their capital. Nabeel reminded the group that lenders bidding to participate would drive down the yield rate to a point just low enough to preserve market participation.

There was also some discussion of whether Treasury funding could ever be truly optional for lenders. Paul Tone asked whether lenders might not be able to afford to participate because the Treasury rate is set more frequently than the student borrower rate. Bob stated that this problem could be solved if the Treasury rate were set annually, just like the borrower rate.

Volume Procurement/Loan Origination Rights Auction

Jim Spaulding presented various proposals on a volume procurement or loan origination rights auction, in which bidders could either (1) bid on the right to originate a certain amount of loans, or (2) bid for the right to serve particular schools or groups of schools.

David Mohning said he opposed multiple lenders serving individual students, resulting from the lenders at a school having to change each year, and that any model that proposed such a measure would be almost unacceptable. He urged the group to consider a sensitivity analysis of how borrowers from various risk groups would be affected. Laurie Wolf echoed David's concerns, inquiring as to whether or not there would be a lender of last resort for those schools for which no lender bid. She also wanted to make sure that the group considered access as important a component of its task as it had considered lender yield rates.

A discussion ensued concerning the timing of the auction and whether or not the direct loan program would still exist. Susan Pugh wondered if schools participating in DL would be exempt from the list of eligible schools upon which lenders could bid. Paul Tone wanted to ensure that the group acknowledged that certain schools have ongoing enrollment cycles. He questioned whether a one-time auction would provide opportunity for student choice throughout the open enrollment cycle. Both Laurie and Judy Case wondered about serialization issues. They questioned whether schools would have appropriate mechanisms, including computer systems, to deal with multiple, possibly unfamiliar lenders. They also expressed concern that student default rates would increase because service quality would decline or because students would be confused by having to deal with multiple lenders. Nabeel stated that the important outcome to consider in the auction process was price, not volume allocation. He maintained that lenders would remain responsive to changes in student demand.

Additional conversation focused on best practices, with Bill Beckmann leading the inquiry as to whether or not FCC or HEAL auctions could provide a reliable model for comparison. Paul Wozniak expressed the view that HEAL auctions are more relevant than other federal government auctions because student loans are the lenders' primary business, while other items the federal government auctions are an incidental part of a business. Jim noted that GAO and Education had reviewed existing government auctions and found that a rights auction would be unique. He clarified by using the case of EPA's emission allowance auctions, in which firms that do not exercise their rights to pollute are actually serving the public interest. In a student loan auction, on the other hand, firms that acquired the right to originate and service loans but choose not to exercise this right would endanger student access to higher education.

Several topics were discussed briefly. One speaker addressed the concern that origination-rights auctions would disrupt long-term lender-school relationships; he stated that a secondary market could enable these relationships to be maintained. Pat Smith urged that the analyses consider students' interest and make clear who the winners and losers would be under each proposal. Bill asked what effect auctions would have on the discounts that lenders now provide to some borrowers. He, Barmak, and Paul Tone also discussed the possibility that, because of barriers to entry, the same lenders were likely to win the auctions each time. If auctions were infrequent, this problem might be less severe because lenders would have a greater incentive to invest the up-front costs of originating loans (knowing that they would be able to continue originating loans for a long time). Nabeel stated that there was no reason the auction had to be an annual process--it could be less frequent. Gail Norris asked for an explanation of the no-volume option and said that there would be a need, under that option, to ensure a sufficient volume of loans by requiring winners to originate a certain volume.

Loan Paper Sale/Auction

David Bergeron introduced the proposal that the federal government (or a non-federal entity acting on behalf of the federal government) originate loans and then conduct an auction in which lenders could bid for servicing arrangements. Variations included differences in when and how often to auction the loans, whether they would have a federal guarantee, and how to structure the stream of payments.

Pat wondered whether or not the government would continue to guarantee the loans against student default and who would bear the risk of default—students or taxpayers. With no guarantee, how would the federal government ensure that lenders provide high-quality service to borrowers? Maureen stated that a guarantee would be unnecessary if it were possible to prequalify some servicers according to service quality.

There was a discussion of exactly what the item to be auctioned should be: financing and/or servicing. Bill described the loans auction as a form of direct lending. He noted that if the federal government is the most efficient provider of capital, then it makes no sense to have the loan community purchase the loans from government. Barmak stated that the federal government could provide funds more efficiently but could never provide service equal to that provided by the independent lenders. David noted that it would be possible to sell student loans either with or without selling the servicing function.

Bill and Art wondered how this system would differ from the current secondary market. Art, Sarah, and Susan Lepper proposed the experimental sale of direct loans for two reasons: (1) to determine the market for government-originated loans and (2) to identify the extent to which such a change in the DL loan program would induce greater competition within the FFELP market.

Ivan Frishberg wondered what role student choice would play in any model that relied on auctions to sort lenders based on bids. He argued that students need the ability to switch away from a lender that provides poor service. At this point, a discussion of income contingency surfaced, with Barmak contending that students default for three reasons: (1) they are unwilling to pay, (2) they aren't aware their payment is due, or (3) they are unable to pay because of income constraints. Pat maintained that the FFEL program should protect needy students against inability to pay. If the federal government were to sell loans to private lenders without a guarantee, she wondered, then how would those students be able to move to income-contingent repayment? Barmak stated that the federal government could discontinue its guarantee of student loans in all cases save those in which students are unable to pay. He advocated a social policy that subsidized the neediest students, sending a signal to lenders that servicing and debt collection should remain high priorities. Bruce Johnstone argued against making a sharp distinction between unwillingness to pay and inability to pay, and in favor of retaining the current federal guarantee. Barmak argued that limiting the federal guarantee to cases of inability to pay would induce lenders to recoup their costs, compelling them to enhance service provision and preclude student loan default (or move borrowers into ICR, perhaps by selling their loans back to the government, if they are about to default).

There was a brief discussion of the costs and benefits of selling loans without a federal guarantee. Art argued that selling loans without a guarantee will cost the federal government money because the government can assume borrowers' default risk more cheaply than private lenders. Barmak responded that selling loans without a guarantee will reduce the federal government's costs because the current guarantee is inefficient. Before moving on, Bill noted that the lenders depend on the government guarantee. Without this backing, lenders would be unable to consider student loans as assets for accounting purposes.

Student Shop

David Bergeron introduced the proposals grouped under the student shop model, discussing both the private alternative loan proposal and the FHA insurance proposal. These would represent the most radical shift in federal student loan policy, in that the borrower's rate would be determined through a market mechanism as well as the lender yield, and borrower rates could differ greatly for different borrowers.

Sarah Ducich stated that this model, while changing some program features, would disrupt FFELP structures less than some of the other models. It was introduced as an alternative to the other models, which all involve auctions to some extent (except for "adjustments to the current system"). Students could be protected in the student shop model by limiting the amount by which their interest rate could vary; this model would introduce price competition with little disruption, while maintaining high levels of service competition. The interest rate cap may also be one of the costliest components of FFELP in CBO's budget baseline model. Eliminating the rate cap would free up money for the government to spend on interest deductions--these could be made refundable, which would target the subsidy to borrowers who need it most.

Some participants expressed concern as to whether and how students would be empowered in this model. Judy Case and Laurie Wolf contended that the burden of negotiation would fall on the institutions and lead to competition among schools for better rates. Laurie expressed concern that schools would try to avoid competition among themselves by forming large consortia to do their bargaining. (She gave the example of public schools within a state banding together to form a consortium.) Nabeel said that in some sense we're in a student shop world already, but schools do the shopping now, and their interests (which may differ from students' interests) include service quality as well as price.

Discussion continued as to the extent of shopping and negotiation that occurs now. Bill said that negotiations do take place, but this has really occurred only in the last few years. With the squeeze in lender yield, market share has become much more important to lenders. David Mohning agreed that some negotiation occurs and pointed out that the lowest interest rate or fees may not always represent the best loan for a given student. Judy and Laurie emphasized the school's role, and Judy added that a large number of lenders or great variability across a number of lenders made the school's task more difficult. Paul Tone noted that negotiations for borrowing rates would not have to be conducted formally between lenders and borrowers/schools. He described a system in which rates could be made public through advertising mechanisms and students could shop around much as borrowers do for car loans or home mortgages.

Bruce Johnstone asked how the student shop model, with a federal guarantee and lender-of-last-resort provision, would produce different results than an origination rights auction. He wondered what incentives students would have to shop for rates when their loans would be subsidized during their academic tenure. Nabeel pointed to the in-school interest subsidy as a disincentive to students' rate-shopping and stated that better incentives are needed for students and schools to negotiate lower interest rates.

There was some discussion of the equity issues that the student shop proposal raises. Paul Tone argued that the proposal would eliminate the current cross-subsidization of high-default-risk students by low-default-risk students, and Bruce expressed concern about this type of change. Bruce said that, even with the federal guarantee, rich students at low-default, high-volume schools would benefit from the spread in interest rates that would exist, while poor students at high-default, low-volume schools would be harmed. The rate spread might not be great, but the direction of the spread would be cause for concern.

Rene Champagne pointed to existing non-federal student loan programs as an illustration of the likely results of competition in the FFEL market. He also argued that competition between the DL and FFEL programs would ensure that FFEL interest rates would decline if the federal government lowered the interest rate on direct loans.

Discussion of Income-Contingent Repayment (ICR)

Maureen McLaughlin introduced several issues for the group to consider in thinking about ICR. (1) How and when would borrower income be verified? (2) What type of IRS involvement, if any, should exist? [Deferring to Liz Askey, from Treasury, Maureen noted that Education had commissioned a number of feasibility studies, confirming that the IRS should not increase its participation in the loan system. Nonetheless, Liz noted that there is authority in the Internal Revenue Code (Section 6103) to disclose certain information to Education regarding student income verification.] (3) Who should pay for loan write-offs? Write-offs after some period of time must be included to achieve true ICR. (4) Who should hold loans that are in ICR--the federal government or private lenders?

Pat urged that the report include a discussion of whether borrowers and/or lenders should be able to choose ICR. Bruce pointed out that ICR could be envisioned in two different ways--protection for those with temporary low income upon graduation, or protection for those with low permanent or lifetime income. Currently, we minimize the number of borrowers going into ICR; other countries in effect put all borrowers into ICR. He added that other countries with ICR use their tax (or public pension) systems to collect payments, but this might not be feasible politically in this country.

Rene raised the possibility that only those who complete a course of study should have an ICR option available. Barmak responded that those who do not complete may need ICR the most and that, if we encourage everyone to attempt postsecondary education, we cannot penalize those who don't make it. Rene agreed that this was the other side of the coin--education is an investment in the country's future and policy should support as many people as possible. Bruce said that 3 parties could pay for the ultimate subsidy needed for ICR with write-offs: all other borrowers (not a progressive option), borrowers who do relatively well (progressive, but possible adverse selection), or the general taxpayer.

Sarah and Bill requested additional information on the ICR option as it is used in the current DL program, such as who chooses this type of repayment, when is it chosen, and what the benefits of this selection are. Barmak contended that little would be learned about the feasibility of an ICR option in FFELP by examining data on the use of ICR in the current DL program. We should get the data, but the incentives in the current system--minimizing monthly payments rather than rational long-term decision-making--may be different from what the incentives might be in a more widespread use of ICR in FFELP.

Bob Cumby brought up the issue of IRS involvement in the collection and income verification processes. He expressed concern about the disadvantages of IRS involvement in either process. Liz Askey stated Treasury's view that IRS should not be involved in collection because the income tax compliance rate falls whenever IRS is involved in collecting non-tax debts. Bill noted that the government doesn't need to be the sole servicer of ICR loans; that is, there is no compelling reason that FFELP couldn't offer the option that DL currently provides. Discussion then followed about possible difficulties involved in sharing data between the IRS and private lenders.

Bruce asked whether the group could get agreement on two issues that had been brought up: whether there are "excess profits" in FFELP today, and whether there are $1 billion of excess federal costs related to private rather than federal funding of FFELP loans. He felt these issues should be empirically verifiable. Bob replied that several agencies studied the question of profitability for quite some time and reached different conclusions, and he thought it was unlikely this group would reach a consensus on either issue.

Next Steps

The meeting concluded with Barbara Bovbjerg's discussion of next steps. She asked for comments on the analysis by August 4. She indicated that the report would most likely devote a separate chapter to each proposal (including a separate chapter for ICR) and that there would not be recommendations. September 21 was scheduled as the date the study group would receive the first draft, with early October being considered for the next study group meeting.